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TO RUEHC/SECSTATE WASHDC PRIORITY 4766
INFO RUEHRI/AMCONSUL RIO DE JANEIRO 1676
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DEPT FOR EWHITE OES/EGC AND PKELLY OES/STC; OES/ETC GTHOMPSON; BSC
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E.O. 12958: N/A
TAGS: TRGY SENV ENRG KSCA ETRD EAGR BR
SUBJECT: BRAZIL'S ADVENTURES IN ETHANOL

¶1. Summary: Ethanol continues to be at the forefront of international politics, as sky-high oil prices have highlighted the necessity to find alternative fuels sources. Brazil, with a 30-year-old alcohol program and a sophisticated production and distribution infrastructure, is a model that many countries are trying to emulate. Yet, for all of the emphasis being placed on ethanol, 2006 has shown alcohol's inherent weaknesses, stemming from limits on expanding production. Although industry in Brazil has managed to stock a considerable amount of ethanol for the January to March intercrop period, demand is increasing more rapidly than sugarcane cultivation (which can only increase at a modest rate since it is a product with a multi-year cultivation cycle). While the flex-car fleet expands by 150% a year, cane acreage expands by less than 10%. This profoundly affects the supply and, therefore, cost of ethanol. Ethanol has become so popular, with more than 80% of new light-vehicle sales in Brazil being flex-fuel and a surge in worldwide demand, that prices have nearly doubled in the past seven months. End Summary

¶2. Steep price increases remain at the forefront of Brazil's present ethanol worries. Since January, prices have risen to 70% the cost of gasoline, in almost every Brazilian state, making it more cost-effective for flex car owners to buy gasoline. Responding to the price increases, the GoB struck a deal with the ethanol industry to erect a wholesale price ceiling of R$1.05/liter. However, by mid-February prices were already hovering at R$1.07/liter and the current mean price is R$1.20/liter. While the GoB has cried foul, industrialists maintain that prices have risen, in spite of the accord, because of "the enormous pressure exercised by the market". The GoB retaliated by reducing the quota of alcohol to be mixed with gasoline from 25-20% and has threatened to impose a system of export quotas, which would afford ethanol treatment similar to that for gasoline, in order to conserve ethanol stocks.

¶3. While there are a number of factors exerting market pressure on ethanol, increased internal and external demand are the most important. According to the Ministry of Agriculture, ethanol exports in January of 2006 were 93% higher than the previous year, and have increased 225% since 2000. As the world's largest sugar and ethanol producer, this is in line with Brazil's future goals to propagate a world ethanol ethos and a market for its product. Additionally, a 10% surge in domestic consumption over the last year, fueled by a boom in flex-fuel car production, has taken analysts by surprise.

¶4. To keep up with increased demand, the sugar/alcohol industry predicts needing investments of R$14 billion by 2010 to increase Brazil's milling capacity by 50% and another R$7 billion to expand crop area. Similarly, the GoB estimates that the sugarcane industry will need an additional R$10 billion in investment by 2012, to add 2.5 million new hectares of planted cane (a 50% increase) and 73 new refineries. Nevertheless, there is still debate concerning how to combat future price fluctuations like those seen this year. The GoB

maintains that it is necessary to shore up the production chain, and Unica is requesting that the government create financial mechanisms or reserve stocks in order to guarantee price stability. According to Unica's Onorio Kitayama, approximaely R$3.5 billion is necessary to guarantee stocs of 5 billion liters which industry estimates wuld maintain price stability. Other industry representatives, however, contend that "high prices during the intercrop period will continue," regardless of an increase in production potential.

¶5. For the present, the Minister for Agriculture Roberto Rodriquez is assuring the public that ethanol stocks will last until ethanol production renews in May, negating claims that there is a "crisis of alcohol". "There is not a crisis, not even a icrocrisis. It is clear that stocks are more thn sufficient." He also affirmed that Brazil has an additional 600 million liters of alcohol stocked away. Although prices are expected to drop slightly with the new harvest/production cycle, the realization that sales will have to be rationed over the next twelve months to guarantee supply means that prices will remain higher than that to which Brazilians are accustomed.

¶6. Comment: Despite government attempts to control prices, market forces make Brazil's current situation demonstrative for two reasons. First, it reveals the hazards of monoculture dependency, especially on a double-tasked crop like sugar, and the need to diversify ethanol sources. Second, the scenario dictates that the present is the proper time for sugar/ethanol producers to invest in order to meet future demands. Further updates on Brazil's ethanol matrix will follow.

CHICOLA